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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Insurance contracts (phase II):**
Discount rates (Agenda Paper 7G)
Recognition and derecognition (Agenda Paper 7H)
Project planning (Agenda Paper 7I)

AGENDA PAPER 7G
DISCOUNT RATES

Purpose of this paper

1. This paper discusses the role of liquidity factors in setting a discount rate for insurance liabilities.

2. This paper does not address:

   (a) risk adjustments. All references in this paper to a discount rate relate to a discount rate that reflects the time value of money, with no consideration of risk.

   (b) discount rates for liabilities whose cash flows depend on asset cash flows (participating contracts, unit-linked (variable) contracts and contracts with discretionary crediting rates, such as universal life contracts)

Recommendations

3. In the staff's view, the objective of the discount rate is to adjust estimated future cash flows for the time value of money. (We are discussing risk adjustments separately, as

well as the credit characteristics of the liability). The discount rate should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and liquidity. The observed discount rate should be adjusted to exclude any factors that influence the observed rate but are not relevant to the liability (for example, risks that are not present in the liability but are present in the instrument used as a benchmark).

4. At this stage, the staff does not recommend further guidance on how to achieve that objective. However, it may be desirable to seek further input on the issues discussed in this paper.

Other topics

5. The staff recommends that the Board not develop guidance in this project on the following topics (not analysed further in this paper):

   (a) How to determine a discount rate for maturities beyond the term of instruments traded in observable markets. This may be an issue for emerging markets, but it may also be a problem to a lesser extent in more developed markets.

   (b) How to develop interest rates for currencies in which there is little or no market in risk-free instruments.

Background

6. Risk-free rates are generally viewed as being the rates observable from market prices of instruments that carry negligible credit risk and are highly liquid. However, some argue that these rates capture both the 'pure' time value of money and an implicit premium[1] for an embedded option to sell the instruments in question (that implicit option premium reduces the discount rate). They argue that this premium does not reduce the discount rate for an illiquid asset. Similarly, they oppose the inclusion of such a premium-deduction in the discount rate for a liability that does not impose significant liquidity needs.

7. An insurer may need some liquidity, but some argue that its liquidity needs are typically less than those of many other holders of highly liquid assets. Therefore, some argue that

[1] Terminology can easily cause confusion here. The implicit option 'premium' increases the price of the investment - which translates into a lower yield and a lower discount rate. Thus, this premium reduces the discount rate, whereas the term 'premium' generally refers in asset pricing to an increase in discount rate.

insurers can capture a liquidity margin by investing in relatively illiquid assets and that insurers often pass on part of that premium to policyholders. An insurer could invest in a highly liquid asset, but if it did so, it would be paying for liquidity it does not need. Therefore, some argue that insurance liabilities should be measured by using a discount rate that is not reduced by the full amount of the implicit option premium implicit in the rate for highly liquid assets.

8. To illustrate, assume the following fact pattern:

   (a) an insurer prices a liability using an expected asset return of 7%, when the return on highly liquid risk-free assets is 5%.

   (b) the insurer estimates that the difference of 2% between the expected asset return and the return on highly liquid risk-free assets arises from the following components:

      (i) liquidity premium: 0.8%

      (ii) premium for bearing other risks associated with the assets (eg default risk): 1.2%

   (c) the insurer estimates that the appropriate liquidity premium for the liability is 0.3%. In other words, the remaining 0.5% (0.8% less 0.3%) of the liquidity premium associated with the risk-free assets is not relevant in determining the discount rate for the liability. The insurer still needs some liquidity to meet unexpected claims or lapses, so part of the liquidity premium is still relevant.

   (d) this example assumes that credit characteristics of the liability have a negligible effect.

9. If the reasoning in paragraphs 6 and 7 is accepted:

   (a) a discount rate of 5.8% would be appropriate for a liability that imposes no liquidity needs, for example, a liability that cannot be called before maturity.

   (b) the insurer would use a discount rate of 5.5% for its insurance liability.

10. The staff understands that some insurance contracts are priced using an expected return on assets that exceeds a government bond rate. If a government bond rate is used with no adjustment for liquidity, a loss is likely to arise at inception of these contracts. An immediate annuity is an example of a contract where this may occur for some insurers.

Meaning of liquidity

11. This paper does not distinguish different aspects of liquidity:

    (a) ability to sell without moving the market price

    (b) ability to find a buyer readily

    (c) ability to sell at low transaction costs

Input from the Insurance Working Group

12. We discussed earlier versions of this paper with the Insurance Working Group. Participants suggested that:

    (a) Insurers are able to capture a liquidity margin. Conceptually, the discount rate ought to reflect this, but quantifying the effect might be difficult.

    (b) A swap rate may sometimes be more relevant than a government bond rate.

    (c) If a swap rate is used, that may eliminate some (perhaps most) of the loss that would be recognised at inception if a government bond rate were used.

Discussion

13. The staff understands that significant losses might arise at the inception of some types of insurance contract, for example, annuities, if a government bond rate is used as the discount rate. There appear to be two possible explanations for such effects (and both may be at work):

    (a) Issuers of such contracts are issuing them at an economic loss, and expecting to make up that loss with investment returns (in effect, capitalising an expected future return).

    (b) A government bond rate omits some factor that is relevant to the liability, or includes some factor that is not relevant to the liabilities. Obvious candidates are:

        (i) Liquidity (as discussed above)

        (ii) The credit characteristics of the liability (a topic we plan to discuss in April).

14. It is only in the last few years that (some) insurers began to think in terms of what now tends to be called ‘market-consistent’ valuation. For example, until recently, it was

common for insurers (in many countries) to include potentially quite onerous guarantees in contracts without making any explicit charge for the guarantees, because it was expected that the guarantees would typically expire out of the money. Another example, in a slightly different context, relates to discount rates for pension liabilities.

15. Given this history, the staff regards it as plausible that some entities may be issuing contracts at a loss and expecting to cover that loss with future investment margins. However, we suspect this is not the only factor, and perhaps not even the most important. In this staff's view, there is something in the notion that a highly liquid government bond contains a liquidity feature that is not always found in an insurance liability. However, there may be some difficulties in quantifying that effect.

16. Some have suggested starting with a high-quality corporate bond rate and deducting a premium for defaults. (That premium would need to capture both expected defaults and the premium for bearing the risk that defaults exceed expectations). The aim would be to arrive at a discount rate reflecting the pure time value of money without a liquidity premium. In the staff's view, that approach might conceivably be appropriate, if the default premium can be estimated reliably and if it is possible to be confident that the bond rate does not include some other factor that is not relevant to the liability.

17. Advocates of using a swap rate have suggested that swap markets are sometimes deeper than government bond markets and can therefore supply more reliable prices.

Staff recommendation

18. In the staff's view, the objective of the discount rate is to adjust estimated future cash flows for the time value of money. (We are discussing risk adjustments separately, as well as the credit characteristics of the liability). The discount rate should be consistent with observable market prices for cash flows whose characteristics match those of the insurance liability in terms of timing, currency and liquidity. The observed discount rate should be adjusted to exclude any factors that influence the observed rate but are not relevant to the liability (for example, risks that are not present in the liability but are present in the instrument used as a benchmark).

19. At this stage, the staff does not recommend further guidance on how to achieve that objective. However, it may be desirable to seek further input on these issues.

AGENDA PAPER 7H
RECOGNITION AND DERECOGNITION

Objective

1. This paper discusses the recognition and derecognition of rights and obligations arising under insurance contracts.

Recognition

2. Paragraph 14 of IAS 39 states: "An entity shall recognise a financial asset or a financial liability on its balance sheet when, and only when, the entity becomes a party to the contractual provisions of the instrument. (See paragraph 38 with respect to regular way purchases of financial assets.)"

3. In the staff's view, a similar requirement is appropriate for insurance contracts.

4. In February, the Board decided the following: When an insurer recognises rights and obligations arising under an insurance contract, it should also recognise as an asset the portion of the customer relationship (relationship with the policyholder) that relates to future payments that the policyholder must make to retain a right to guaranteed insurability.

5. Agenda paper 7D contains draft guidance on estimating cash flows. The draft emphasises that the measurement of an insurance contract incorporates cash flows from existing contracts, not cash flows from possible future contracts.

Derecognition

6. Paragraph 14(c) of IFRS 4 states: [an insurer] shall remove an insurance liability (or a part of an insurance liability) from its balance sheet when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

7. Paragraph 105 of the Basis for Conclusions on IFRS 4 gives the following explanation.

> The Board identified no reasons why derecognition requirements for insurance liabilities and insurance assets should differ from those for financial liabilities and financial assets. Therefore, the derecognition requirements for insurance liabilities are the same as for financial liabilities (see paragraph 14(c) of the IFRS). However, because derecognition of financial assets is a controversial topic, the IFRS does not address derecognition of insurance assets.

8. The staff regards those conclusions as still valid.

AGENDA PAPER 7I
PROJECT PLANNING

Purpose of this paper

1. This paper gives an overview of topics the staff expects to ask the Board to discuss over the next few months, and the projected timing.

Topic and brief summary of content	**IASB meeting**
Universal life contracts. Universal life contracts give more discretion than traditional life insurance contracts to both policyholders and the insurer. What effect does such discretion have on recognition and measurement?	April 2006
Unit of account. At what level should insurance contracts be aggregated for measurement?	April 2006
Measurement attribute. Should the measurement attribute for insurance liabilities be current entry value or current exit value?	April 2006
Unit-linked and index-linked payments. How should an insurer: • measure obligations denominated in units of an internal or external investment fund? • measure and present the assets of an internal fund linked to such obligations? • account for revenue (eg investment management fees) and expense (including acquisition costs) related to such contracts? • measure guarantees of unit prices?	April 2006
Profit margins. Should margins be included in relation to explicit or implicit fees for future services (eg future investment management fees)?	April 2006
Unbundling. Should an insurer unbundle the individual elements of an insurance contract and measure them individually?	April 2006

Credit characteristics of insurance liabilities. Should the measurement of insurance liabilities include the effect of their credit characteristics? If so, what is the effect of guarantee funds?	April 2006
Reinsurance ceded How should a cedant measure its rights under a reinsurance contract? Does the answer have implications for policyholder accounting? (We do not plan to address policyholder accounting in the Discussion Paper, but plan to cover it in the Exposure Draft.)	May 2006
Reinsurance assumed Do reinsurance contracts have any characteristics that might justify treatments that differ from those proposed for direct insurance contracts?	May 2006
Changes in insurance liabilities. Which components of changes in insurance liabilities should an insurer report separately? Should an insurer recognise some or all premium receipts as deposit receipts rather than revenue?	May 2006
Salvage and subrogation How should salvage and subrogation rights be treated?	May 2006
Business combinations and portfolio transfers. To consider whether the Discussion Paper needs to address insurance contracts acquired in business combinations and portfolio transfers	May 2006
Long-term savings contracts. To consider whether any conclusions reached for insurance contracts have implications for the treatment of long-term savings contracts.	May 2006
Overview of relevant FASB projects. To review developments in FASB projects on risk transfer, life settlements and financial guarantees, and assess whether there are any implications for the discussion paper.	May 2006
Participation features (follow up issues). Depends to some extent on decisions in March. Possible topics include impact of insurer discretion of guarantees and mutuals.	May 2006

Insurance Working Group meeting	29-30 June 2006
First pre-ballot draft	July 2006
Second pre-ballot draft	September 2006
Ballot draft	November 2006
Publication	December 2006